Collective Investment Funds Re-emerge as Mainstream Investment Option

Why the comeback? A demand for lower expenses and more flexibility make qualified plans a major market

Collective investment funds, sometimes referred to as common trust funds, are not a new investment structure in the U.S. market. In fact, they have been available in the market for decades, to both defined-benefit and defined-contribution plans.

In the past, however, collective investment funds had also always been perceived as a bank product, and mutual fund companies were, for several decades, the growth leaders in the retirement plan arena. As 401(k) plans began to grow quickly in the 1980s, they found mutual funds an easy-to-use product, further slowing the development of collective investment funds.

Now, collective investment funds are making a very strong comeback for several reasons. The primary factor in the last few years has been faster computers and better communication networks. These have allowed collective investment funds to be priced and traded on a daily basis. Collective investment funds are remarkably similar to the mutual funds many of us are familiar with in the marketplace; they can invest in equities, fixed income, ETFs and even mutual funds. Additionally, they can create custom asset allocation portfolios to meet the needs of a particular client. This feature has been extensively used by pension plans that desire the collective investment funds to be utilized as a life-cycle fund.

While many pension plan sponsors had shied away from including collective investment funds in their employees' plans in the past, there are now more than 1000 collective investment funds available, and that number keeps growing. Many of the collective investment funds available today are near mirror images of mutual funds that asset managers already offer to pension plans. In fact, some of the stable value funds already available are so identical to the mutual funds they mirror that many plan participants are unaware of the transition from mutual fund to collective investment trust.

There are a few key differences, however, which make them remarkably well suited for use within 401(k) retirement plans.

The Market

There are several factors which make CIFs different from mutual funds. Nearly all of them are helping drive more and more business toward the collective investment trust market. While collective investment funds have been available to institutional investors and large pension funds for decades, they have gained increased popularity as of late for a number of reasons.

Long the domain of private equity and hedge funds, mainstream mandates are being increasingly found in non-registered products. Investment managers that have traditionally offered registered funds (mutual funds) are showing considerable interest in non-Securities Exchange Commission (SEC) registered vehicles as of late, such as collective investment funds. Investment managers are looking to commingle separately managed accounts to save on operational costs, and roll them into collective investment funds.

Investment managers have realized that the growing collective investment trust market can provide them with access to new markets, lessen their cost burdens related to increasingly complex regulations, give them a faster time to market, and decrease their costs. This has resulted in collective investment funds being found in most pension plans in the United States.

The ability of mutual funds to be offered to a wide variety of investors, from institutional to retail, means that they have assets coming in from a wide variety of distribution channels.

When compared to collective investment funds, this proves to be a disadvantage for the mutual funds, as the necessary record-keeping, tracking, trading and fee allocation add an enormous burden to the mutual fund firms and their custodians. Collective investment trusts, offered exclusively to institutional investors, are able to avoid this added burden.

Regulatory Changes

The Pension Protection Act (PPA) of 2006 created a big boost for CIFs. The PPA strongly encourages companies to set up automatic enrollment for their employees into default investment plans, referred to as "Qualified Default Investment Alternatives" (QDIA).

These can be balanced accounts, target-date (life-cycle) funds, or managed accounts. Many employers are scrambling to comply with the PPA, and are setting up new 401(k)s, or setting up automatic enrollment plans for their employees to contribute to their pre-existing 401(k) plans.

However, while one aspect of the PPA has driven employers to set up automatic enrollment plans (helping mutual funds, ETFs and collective investment funds), there is another aspect of the PPA that has driven business specifically toward collective investment funds: That is the requirement for plan sponsors to act in the interest of their participants and seek out low-cost options to be included within their 401(k)s.

This has spurred the trend toward low-cost investment solutions in order for employers to protect themselves from a fiduciary point of view.

• The Department of Labor (DOL) has also debated the possibility of including target-date and target-risk collective investment funds within its selection of acceptable default investments in pensions, under the PPA.

• The Government Accountability Office (GAO) has also conducted an investigation into the fees being charged in 401(k) plans, further driving plan sponsors away from mutual funds and toward lower cost alternatives.

• Collective investment funds are not regulated by the Securities and Exchange Commission, and are exempt from Section 3(c) (11) of the Investment Company Act of 1940 (more commonly referred to as the "40 Act"). While this may appear to be a minor difference between collective investment funds and mutual funds at the surface, this is a key factor, which affects the attractiveness of collective investment trusts to 401(k) plans greatly. The reason for this is that collective investment trusts, being exempt from oversight by the SEC, are not required to adhere to the strict regulations imposed by the 40 Act. These regulations stipulate, among other things, that mutual funds provide prospectuses to potential investors and provide regular written reports on the status of the fund.

Regulation of CIFs

Instead of being regulated by the SEC, collective investment funds fall under the auspices of the government's Office of the Comptroller of the Currency, which is part of the U.S. Treasury Department. The ability of the collective investment trust not to be burdened by the cumbersome requirements imposed by the SEC — as well as by the enormous amount of expenses associated with the production and printing of prospectuses and reports — already helps to make collective investment funds more attractive to pension plans.

Yet, they're not being regulated under the 1940 Act shuts collective investment funds out of the 403(b) plan market, as 403(b) plans stipulate that only funds which fall under the 1940 Act be included in their offerings. Unfortunately for collective investment funds, this has locked them out of many teacher and non-profit pension plans, and there does not seem to be any legislation on the horizon to remedy this.

Requirements for CIFs

Collective investment trusts are required to be valued at least once every three months (although, realistically, most collective investment funds are now valued at least monthly, and many much more frequently). There is an exception to

this rule: collective investment funds which are primarily invested in real estate or other assets and which are not readily marketable (in these cases, the collective investment trust should be valued at least once a year).

Also, at least once during each 12-month period, a savings association administering the collective investment trust must arrange for an audit of the collective investment trust, and the collective investment trust must also provide a report summarizing security purchases (with their costs), a summary of sales (with profit and loss and any other investment changes), income and disbursements, and an appropriate notation of any investments in default.

Collective investment funds are not allowed to be sold directly to retail investors, as they are not regulated by the SEC. Instead, they are only saleable to institutional investors, and are generally sold into Defined Benefit and Defined Contribution plans.

Because they are not sold directly to retail investors, not only do collective investment funds avoid the costs of printing materials such as prospectuses, but they are not burdened by expensive administrative, advertising and marketing costs. Collective investment trusts also avoid the cost and rigmarole of supporting toll-free telephone service centers and dealing with retail investor inquiries.

In lieu of a prospectus, a collective investment fund is able to issue a much shorter and simpler "disclosure statement" to investors. Collective investment trusts must also file a trust document with the IRS for a determination letter, and also must file a form 5500 annually. Collective investment funds do not issue proxies, helping to further reduce their cost.

Another factor to bear in mind when dealing with collective investment funds is that they must be held and offered by a bank or trust company (generally a bank or custodian). Technically, it is the bank or custodian that is the trustee of the collective investment trust. If, in theory, the selected asset manager were to not perform their duties, they could be replaced by another manager.

CIF ETFs

There has also been a group of collective investment funds designed around holding only ETFs as the underlying portfolio. Not only does this provide a cost savings of approximately 60 to 80 basis points per collective investment trust, but it also provides a much greater diversification for the portfolio. The individual ETFs are combined to build an investment strategy in the same fashion that stocks or bonds would be in a traditional collective investment trust.

The difficulty is that the selection of ETFs is rather limited, with a much more finite number of ETFs than individual securities. Despite their limited number, ETFs have more than US$400 billion in assets under management in the United States alone. Even so, ETFs can present their own set of technological issues in regard to their pricing. The transaction costs associated with weekly automatic contributions or from active trading have the possibility of negating any cost savings to be gained from lower expense ratios.

Some custodians have had difficulties in addressing the needs of ETF managers who require much more rapid delivery of real-time or near-real-time information.

Also, many 401(k)s using ETFs are looking to bundle trades, in order to spread transaction costs across multiple users, which presents further technical issues (especially involving record-keeping). ETFs will still have a difficult time being fully accepted by 401(k)s, primarily due to technological issues.

But the reality is that investors are asking for ETFs, and plan providers will sooner or later have to develop or purchase the technology to cater to the growing number of ETFs investors are asking for.

Midsize investment management firms are rapidly developing new collective investment funds to cater to smaller pension plans present in the market, as well as offering niche products to the larger pension plans which are looking to provide diversified investments to their pension participants.

The collective investment funds' attractiveness is driven by two key factors: low cost and ease of use. The primary driver for the inherently low cost for collective investment fund is the less rigorous regulatory burdens placed upon the investment managers and trustee. In order to attain the lowest possible cost, however, all parties involved need to seek the trustee able to offer the lowest servicing cost. In order for a trustee to accomplish this, their process must be as fully automated as possible, with as little manual intervention as possible.

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